

2010

# Case Note: Knight and the 2% Floor: Still in Search of a Workable Standard to Evaluate the Tax Deductibility of Fiduciary Expenses—Knight v. Commissioner

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## Recommended Citation

O'Tool, Nathan R. (2010) "Case Note: Knight and the 2% Floor: Still in Search of a Workable Standard to Evaluate the Tax Deductibility of Fiduciary Expenses—Knight v. Commissioner," *William Mitchell Law Review*: Vol. 36: Iss. 3, Article 11. Available at: <http://open.mitchellhamline.edu/wmlr/vol36/iss3/11>

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**CASE NOTE: *KNIGHT* AND THE 2% FLOOR: STILL IN  
SEARCH OF A WORKABLE STANDARD TO EVALUATE  
THE TAX DEDUCTIBILITY OF FIDUCIARY EXPENSES—  
*KNIGHT V. COMMISSIONER***

Nathan R. O'Tool<sup>†</sup>

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I. INTRODUCTION

In January 2008, the United States Supreme Court issued a unanimous decision which held that investment advisory fees paid by a trust may not be deducted in full for income tax purposes.<sup>1</sup> The

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previous sentence may prompt 95% of readers to put this case note down and continue on with their business. Admittedly, tax law—specifically, income tax law as it pertains to trusts and estates—is not the sexiest topic. The outcome of this seemingly mundane topic, however, has multi-million dollar consequences for both the government and those who rely on trusts for income. There are nearly four million estates and trusts that outsource roughly \$10.2 billion a year for legal, accounting, tax reporting and asset management services.<sup>2</sup> In addition to these expenses these trusts and estates also pay trustees an additional \$4 billion for their asset-management services.<sup>3</sup> Needless to say, the tax revenue to be gained by the government and the income to be lost for beneficiaries are substantial and warrant attention from even non-tax professionals.

This case note will first provide a brief statutory history of Internal Revenue Code Section 67 and a basic outline of how the federal income tax is calculated.<sup>4</sup> It will then provide a brief synopsis of the jurisdictional split as to the deductibility issues among federal circuit courts of appeals.<sup>5</sup> It will proceed with a discussion of both the factual<sup>6</sup> and procedural<sup>7</sup> setting of the *Knight* decision in addition to the proposed regulations set forth by the Department of the Treasury (Treasury).<sup>8</sup> This discussion will be followed by the Supreme Court's holding based on those facts<sup>9</sup> and will conclude with an analysis of the opinion<sup>10</sup> and the Treasury's proposed regulations.<sup>11</sup> The purpose of this note is to evaluate the practical effects of both the current proposed regulations to section 67(e) and the possible amendments to these proposed regulations in light of the Supreme Court's holding in *Knight*.

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experience. He would also like to thank his parents for their support over the years and the *William Mitchell Law Review* staff for their efforts in preparing this article for publication.

1. *Knight v. Comm'r*, 552 U.S. 181 (2008).
2. Tom Herman, *Trust-Fees Ruling Causes Pain – Justices Decision Limits Deductions for Tax Purposes*, WALL ST. J., Jan. 23, 2008, at D6.
3. *Id.* (citing Eileen Sher, a tax technical manager at the American Institute of Certified Public Accountants in Washington).
4. *See infra*, Part II(A).
5. *See infra*, Part II(B).
6. *See infra*, Part III(A).
7. *See infra*, Part III(B).
8. *See infra*, Part III(C).
9. *See infra*, Part IV.
10. *See infra*, Part V(A).
11. *See infra*, Part V(B).

## II. HISTORY

### A. Statutory Background

Section 1 of the Internal Revenue Code (the Code) imposes a tax on all “taxable income” of both individuals and trusts.<sup>12</sup> In order to calculate taxable income, a taxpayer must first determine the amount of his or her “gross income.”<sup>13</sup> Gross income is defined as “all income from whatever source derived.”<sup>14</sup> “Adjusted gross income” is then determined by subtracting from gross income certain “above-the-line” deductions, such as trade and business expenses.<sup>15</sup> “Taxable income” is then calculated by subtracting “itemized deductions” — also known as “below-the-line” deductions—from the taxpayer’s adjusted gross income.<sup>16</sup>

Prior to the passage of the Tax Reform Act of 1986, below-the-line deductions were fully deductible from a taxpayer’s adjusted gross income.<sup>17</sup> Complexities and inefficiencies arose out of this system for both the taxpayers and the IRS.<sup>18</sup> Taxpayers were required to keep extensive records of their common expenditures which in turn caused “significant administrative and enforcement problems for the [IRS].”<sup>19</sup> This complexity and the correlating potential for abuse led Congress to enact what is commonly referred to as the “2% floor” by adding section 67 to the Code.<sup>20</sup>

Section 67(a) states that “the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.”<sup>21</sup> Section 67(b) then goes on to exempt from the 2% floor

12. I.R.C. § 1(a)-(e) (2010).

13. *William L. Rudkin Testamentary Trust v. Comm’r*, 467 F.3d 149, 152 (2d Cir. 2006).

14. I.R.C. § 61(a) (2010). “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived . . .” *Id.*

15. I.R.C. § 62(a) (2010). Section 62(a) outlines twenty deductions that may be subtracted from a taxpayer’s gross income to reach his or her adjusted gross income. *Id.*

16. I.R.C. § 63 (2010).

17. *Knight v. Comm’r*, 552 U.S. 181, 184 (2008).

18. *Id.*

19. *Id.* (quoting H.R. Rep. No. 99-426, at 109 (1985)).

20. *Id.*

21. I.R.C. § 67(a) (2010). “The utility of itemized deductions generally depends upon whether in the aggregate (after a 2 percent floor imposed on some itemized deductions and a reduction in most itemized deductions of high-income taxpayers) they exceed the ‘standard deduction.’” JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 575 (Foundation Press 2009) (1972). The standard

certain specifically enumerated itemized deductions.<sup>22</sup> Investment advisory fees are typically treated as itemized deductions under Section 212.<sup>23</sup> However, because they are not listed in section 67(b), these fees are subject to the 2% floor established by section 67(a).<sup>24</sup>

Section 67(e) extends the application of the 2% floor to the miscellaneous itemized deductions of trusts and estates with one exception relevant to this particular case note.<sup>25</sup> A trust's costs are deductible in full (not subject to the 2% floor) "if they satisfy both of the following two requirements: (1) they are 'paid or incurred in connection with the administration of the . . . trust'; and (2) they 'would not have been incurred if the property were not held in such trust.'"<sup>26</sup>

### B. *Jurisdictional Splits*<sup>27</sup>

deduction came into the Code in 1944 as a way to ease the burden of administration. *Id.* If a taxpayer's itemized deductions did not surpass the 2% floor of section 67, or if he simply chose not to itemize his deductions, the taxpayer could punt and claim the standard deduction. *Id.* The standard deduction was seen to ease the burden of both the taxpayer and the IRS. *Id.* at 574-77.

22. William L. Rudkin Testamentary Trust v. Comm'r, 467 F.3d 149, 153 (2006).

23. *Id.* See also I.R.C. § 212 (2010). Section 212 allows for a deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income; (2) for the management, conservation or maintenance of property held for the production of income . . . ." *Id.*

24. *Rudkin Testamentary Trust*, 467 F.3d at 153. See also Temp. Treas. Reg. § 1.67-1T(a)(1)(ii) (1988) (stating that investment advisory fees are subject to the 2% floor of § 67(a)).

25. I.R.C. § 67(e) (2010).

26. *Rudkin Testamentary Trust*, 467 F.3d at 151 (quoting I.R.C. § 67(e)).

27. The three cases that follow in this section highlight an interesting aspect of federal income tax law; namely that there are three separate routes in which a taxpayer may litigate an income tax deficiency controversy. JAMES J. FREELAND ET AL., *supra* note 21, at 968. The first route is through the Tax Court. A taxpayer, without actually paying the claimed tax deficiency, may file a petition in Tax Court. If the Tax Court affirms the Commissioner's claimed deficiency, the taxpayer may then file an appeal with the United States Court of Appeals in the circuit in which he or she resides. If the taxpayer wishes to forgo any possible administrative remedies available to him under the Tax Court route, he may choose to pay the deficiency in full and file a claim in federal district court for an income tax refund. Any appeal from the district court would go to the appeals circuit in which he or she resides. The last route is through the United States Court of Federal Claims. Like the federal district court route, a taxpayer must pay the claimed deficiency in full prior to initiating a suit in the Court of Federal Claims. Unlike the district court route, there is no jury trial available in this forum and its organization and procedures are very similar to that of the Tax Court. Any appeal from this court goes to the United States Court of Appeals for the Federal Circuit. There are numerous tactical reasons a taxpayer may choose one forum over another, however, if a taxpayer chooses to pay less than the deficiency

### 1. *The Sixth Circuit: O'Neill v. Commissioner*

The first fully litigated case on the issue of the deductibility of trust or estate investment advisory fees was *O'Neill v. Commissioner*.<sup>28</sup> For the 1987 taxable year, the first year in which the 2% floor was in effect, the co-trustees of the William J. O'Neill, Jr. Irrevocable Trust (the O'Neill Trust) deducted, in full, \$15,374 of investment advisory fees incurred by the trust.<sup>29</sup> The Commissioner of the Internal Revenue Service subsequently issued a Notice of Deficiency for \$3534 in tax owed by the trust finding that the investment advisory fees constituted a "miscellaneous itemized deduction" under section 67(a).<sup>30</sup>

Following the filing of a petition for redetermination, the Tax Court upheld the Commissioner's position and found that the investment advisory fees were not described in section 67(e) (1) and were, therefore, subject to the 2% floor.<sup>31</sup> The Tax Court stated that "the thrust of the language of section 67(e) is that only those costs which are *unique* to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions set forth at section 67(a)."<sup>32</sup>

The United States Court of Appeals for the Sixth Circuit reversed.<sup>33</sup> It based its reasoning on a fiduciary's responsibility to invest and manage trust assets as a "prudent investor" would manage his own assets.<sup>34</sup> The Sixth Circuit found that where a trustee lacks experience in investment matters, his fiduciary duties require him to retain the services of an investment advisor so as not to put the trust assets at risk.<sup>35</sup> Because the investment advisory fees were caused by

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asserted, the taxpayer's only remedy is a deficiency proceeding in the Tax Court. *Id.*

28. 994 F.2d 302 (6th Cir. 1993), *abrogated by* Knight v. Comm'r, 552 U.S. 181 (2008).

29. *Id.* at 303. In 1987, the market value of the O'Neill Trust exceeded \$4.5 million. *Id.* From 1979 to 1991, the co-trustees had engaged Hamilton & Allen (f.k.a. Allen & Leavy Investment Management, Inc.) to provide investment management services for the O'Neill Trust. *Id.*

30. *Id.* The result of the Commissioner's findings increased the O'Neill Trust's taxable income by \$9180. *Id.*

31. *Id.* at 304.

32. *Id.* (quotations omitted).

33. *Id.*

34. *Id.* at 304.

35. *Id.* See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 reporter's notes (1990) ("The prudent investor rule of this Section has its origins in the dictum of *Harvard College v. Amory*, 9 Pick. (26 Mass) 446, 461 (1830), stating that trustees must 'observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent

the fiduciary duties of the co-trustees, the Sixth Circuit found that the fees were incurred in connection with the administration of the trust and were, therefore, fully deductible and not subject to the 2% floor of section 67(a).<sup>36</sup>

Subsequent to the ruling of the Sixth Circuit, the IRS nonacquiesced but opted not to seek certiorari due to the lack of conflict among the circuit courts of appeals.<sup>37</sup> The IRS did, however, encourage parties in other circuits to follow the Tax Court's opinion in hopes of developing inter-circuit conflict.<sup>38</sup> The IRS would soon get their wish as the *O'Neill* opinion marked the first—and last—time that a circuit court would agree with the taxpayer's position on the deductibility of investment advisory fees by trusts.<sup>39</sup> In 2000, the Court of Federal Claims agreed with the IRS's position.<sup>40</sup>

## 2. *The Federal Circuit: Mellon Bank v. United States*

In the years 1989 through 1992, Mellon Bank filed fiduciary income tax returns for thirteen trusts created for the benefit of members of the Richard K. Mellon family.<sup>41</sup> In each of these years Mellon Bank applied the 2% floor to the investment management fees incurred by the trusts.<sup>42</sup> Relying on *O'Neill v. Commissioner of Internal Revenue*,<sup>43</sup> in October 1993, Mellon bank filed an amended fiduciary income tax return seeking a consolidated tax refund of income taxes paid in years 1989 through 1992.<sup>44</sup> The IRS denied the

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disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”).

36. *O'Neill*, 994 F.2d at 304. This line of reasoning would later be put forth by the trustee in *Knight v. Commissioner* and be referred to as the “straightforward causation test.” *Knight v. Comm’r*, 552 U.S. 181, 189 (2008).

37. *O'Neill*, 994 F.2d 302, *action on dec.*, 1994-06 (Sept. 12, 1994) (providing direction as to how taxpayers should approach this decision: “[t]he Service agrees with the Tax Court and disagrees with the Sixth Circuit. No petition for a writ of certiorari was filed, however, in the absence of inter-circuit conflict. Deductions for fees for investment advice incurred by trusts or estates should continue to be subject to the 2[%] floor in section 67 outside the Sixth Circuit. While the Sixth Circuit’s decision should be followed there, the Tax Court opinion should be followed in other circuits in hope of developing inter-circuit conflict.”).

38. *Id.*

39. Philip N. Jones, *Supreme Court Rules—Negatively—on Deductibility of Trust Investment Advisor Fees*, 108 J. TAX’N 72, 73 (2008).

40. *Id.*

41. *Mellon Bank v. United States*, 265 F.3d 1275, 1277 (Fed. Cir. 2001).

42. Jones, *supra* note 39, at 73.

43. 994 F.2d 302 (6th Cir.1993), *abrogated by Knight v. Comm’r*, 552 U.S. 181 (2008).

44. *Mellon*, 265 F.3d at 1278.

refund claim, and the bank filed suit in the Court of Federal Claims.<sup>45</sup> After the submission of stipulated facts,<sup>46</sup> the trial court entered judgment on the merits in favor of the United States.<sup>47</sup> Taking issue with the trial court's construction of the statute, Mellon Bank appealed.<sup>48</sup>

It was undisputed that trustee fees are fully deductible.<sup>49</sup> Mellon Bank maintained that the "trustee fees are merely a label for fiduciary services performed by the trustee."<sup>50</sup> It argued that because these fiduciary services are required by law, any services that are delegated by the trustee—specifically, investment advisory fees—would remain subject to fiduciary standards and are, therefore, trustee fees fully deductible under section 67(e)(1).<sup>51</sup>

The question addressed by the United States Court of Appeals for the Federal Circuit was whether the Court of Federal Claims, in rejecting Mellon Bank's interpretation, properly interpreted the second requirement of section 67(e)(1) to mean that a trustee's costs are subject to the 2% floor established by section 67(a) unless the costs occur *only* in the context of trust administration and are *not routinely* incurred by individual investors.<sup>52</sup> The Federal Circuit found that that it had and affirmed.<sup>53</sup>

In doing so, the Federal Circuit looked closely at the two-pronged test of section 67(e)(1).<sup>54</sup> The first prong of the test states that fees are fully deductible if they are "costs which are paid or incurred in connection with the administration of the estate or trust."<sup>55</sup> The court stated that this prong serves as a prerequisite which defines the relationship between the costs and the administration of the trust.<sup>56</sup> It

45. *Id.* Following the initiation of the suit in the Court of Federal Claims, both parties filed motions for summary judgment. *Id.* Both motions were subsequently denied by the court. *Id.* The court denied the government's motion because they found that there were material issues of fact as to whether certain expenditures deducted by the bank would not have been incurred if the property were not held in a trust. *Id.* The court rejected Mellon Bank's interpretation of section 67(e)(1) and therefore denied its motion. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at 1279.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 1281–82.

54. *Id.* at 1280–81.

55. I.R.C. § 67(e)(1) (2010).

56. *Mellon*, 265 F.3d at 1280.



logically follows that all expenses resulting from the fiduciary obligations of the trustee satisfy this prerequisite.<sup>57</sup> It is at this point that the court rejected Mellon Bank's interpretation. Under the bank's interpretation, this is where the analysis would stop because the bank argues that trustee fees are merely a label for fiduciary costs.<sup>58</sup> Therefore all expenses incurred by a trustee in connection with the administration of a trust would be fully deductible.<sup>59</sup> This interpretation, however, would eliminate the second prong of section 67(e) (1), which is directed to the question of whether an expense would not have been incurred if the property had not been held in trust.<sup>60</sup>

The court refused to adopt Mellon Bank's interpretation because it would render the second prong of section 67(e) (1) superfluous.<sup>61</sup> Instead it found that the second prong served as a filter that allowed a full deduction only if such fees were costs that "would not have been incurred if the property were not held in such trust or estate."<sup>62</sup> This requirement did not focus on the "relationship between the trust and costs, but the type of costs, and whether those costs would have been incurred" had the assets been held outside of a trust.<sup>63</sup> The second prong, therefore, "treats as fully deductible only those trust-related administrative expenses that are *unique* to the administration of a trust and not customarily incurred outside of trusts."<sup>64</sup> Investment advisory fees, the court found, are commonly incurred outside of trusts and are therefore *not* exempt under section 67(e) (1) and are subject to the 2% floor of section 67(a).<sup>65</sup>

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57. *Id.*

58. *Id.* at 1279.

59. *Id.* at 1280.

60. I.R.C. § 67(e) (1) (2010).

61. *Id.* "Our interpretation, however, must give full effect to the entire statute, not merely the first clause." *Mellon*, 265 F.3d at 1280 (citing *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998) ("[W]e are hesitant to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law.")).

62. *Mellon*, 265 F.3d at 1280.

63. *Id.* at 1281.

64. *Id.* (emphasis added).

65. *Id.* In the last paragraph of its opinion, the Federal Circuit noted that Mellon Bank "had chosen to retain an outside investment advisor," and thus they "must accept the tax consequences of that decision." Jones, *supra* note 39, at 73. This comment seems to imply "that the bank's fees would have been fully deductible had the bank bundled all of its fees into a single trustee's fee." *Id.*

### 3. *The Fourth Circuit: Scott v. United States*<sup>66</sup>

On October 16, 1944, the Bryan Trust was established under the last will and testament of John Stewart Bryan.<sup>67</sup> The Bryan Trust was established for the benefit of John Bryan's four granddaughters.<sup>68</sup> The Trust authorized its trustees to employ investment advisors and to pay those advisors reasonable fees for their services.<sup>69</sup> Consistent with this authorization, the trustees of the Bryan Trust, three attorneys,<sup>70</sup> retained the investment-counseling firm of Brundage, Sotry and Rose, LLC (Brundage).<sup>71</sup> During the tax years at issue in this case, 1996 and 1997, the Bryan Trust held assets worth approximately \$25 million. In 1996 and 1997, respectively, the Trust paid Brundage \$107,055 and \$119,943 in investment advisory fees.<sup>72</sup> In addition to the investment advisory fees, "the Trust also paid custodian fees, trustees' fees, and fees for the preparation of [fiduciary] income tax returns and accountings."<sup>73</sup>

On both the 1996 and 1997 fiduciary income tax returns, the taxpayers reported the investment advisory fees paid to Brundage as "'other deductions,' not subject to the 2% floor for miscellaneous itemized deductions."<sup>74</sup> Following an audit, the "IRS determined that the investment . . . [advisory] fees were . . . miscellaneous itemized deductions subject to the 2% floor" and issued a notice of deficiency.<sup>75</sup> In 2000, the taxpayers paid the deficiency and, after their refund claim was denied by the IRS, filed a refund suit in Federal District Court.<sup>76</sup>

The Government filed a motion for summary judgment relying on the Federal Circuit's decision in *Mellon Bank*.<sup>77</sup> The taxpayers then filed a cross motion for summary judgment relying on the Sixth

66. *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003).

67. *Id.* at 135. The Trust was established under Virginia law. *Id.*

68. *Id.* "These granddaughters include[d] taxpayers Shelah K. Scott, Hope S. Childs, and Anne K. McGuire." *Id.*

69. *Id.*

70. *Id.* at 136. The income beneficiaries of the trust all claimed that the trustees all lacked expertise in the investment of large sums of money and would not have served without an outside investment advisor. *Id.*

71. *Id.* at 135.

72. *Id.* at 136.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* The taxpayers each filed their own refund suits in the Eastern District of Virginia. These suits were consolidated immediately after they were filed. *Id.*

77. *Id.*

Circuit's decision in *O'Neill*.<sup>78</sup> "At oral argument on the motions, the court raised a new issue" regarding the immunity Virginia law<sup>79</sup> "afforded . . . to trustees who invest trust assets in a statutory list of approved investments."<sup>80</sup> "After further briefing and argument" on this statutory immunity issue, "the court granted the Government's motion for summary judgment."<sup>81</sup> The court reasoned that because trustees had access to this list of investments, and would be immune from liability for any losses or damages if these investments were used, an investment advisor was not required.<sup>82</sup> Because retaining an investment advisor to manage the trust assets was not required under the trustees' fiduciary duty, the court found the associated fees to be subject to the 2% floor of section 67(a).<sup>83</sup>

On appeal, the Fourth Circuit affirmed the trial court's ruling but on different grounds.<sup>84</sup> Rather than relying on Virginia law,<sup>85</sup> the court focused on the commonality in which investment advisory fees are incurred by individuals and trusts.<sup>86</sup> Relying on *Mellon Bank*, the court stated simply that "trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers."<sup>87</sup> Because investment advisory fees are commonly incurred outside the context of trust administration, they are, therefore, subject to the 2% floor.<sup>88</sup> The court also noted what it

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78. *Id.*

79. *See* VA. CODE ANN. §§ 26-45.3, 45.14 (2009).

80. *Scott*, 328 F.3d at 136. "The court sought additional briefing on the potential impact of that immunity on the deductibility of investment-advice fees." *Id.*

81. *Id.*

82. *Id.* at 137.

83. *Id.* "The [district] court acknowledged that investments authorized by the Virginia legal list might not be the best investments from a financial perspective and that trustees 'would probably be better served' by seeking investment advice." *Id.*

84. *Id.* at 140.

85. The Fourth Circuit was right to base its decision on other grounds. Basing the outcome of a federal income tax question on state law, when not expressly authorized, runs contrary to settled precedent. *See* *Lyeth v. Hoey*, 305 U.S. 188, 194 (1938) ("In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income . . . it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted so as to give a uniform application to a nationwide scheme of taxation. . . . Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law.") (internal quotations omitted).

86. *Scott*, 328 F.3d at 140.

87. *Id.*

88. *Id.*

saw as a “fatal flaw” of the Sixth Circuit’s reasoning in *O’Neill*.<sup>89</sup> The test was not whether such costs were commonly incurred by trustees, but rather whether such costs were commonly incurred outside of trusts.<sup>90</sup> The score was, therefore, two circuits to one in favor of the IRS.

### III. THE *KNIGHT* FACTS AND PROCEDURAL HISTORY

#### A. *The Rudkin (Knight) Facts*

Michael J. Knight (Knight) served as trustee of the William L. Rudkin Testamentary Trust (trust) established in Connecticut under the will of Henry A. Rudkin on April 14, 1967.<sup>91</sup> The trust was initially funded with proceeds from the sale of Pepperidge Farm to Campbell Soup Company.<sup>92</sup> The trustees and other fiduciaries were provided with broad authority in the management of the trust property.<sup>93</sup> The trust authorized the trustees “to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management of [the] estate and of any trust created [thereunder].”<sup>94</sup>

In 2000, Knight engaged Warfield Associates, Inc. (Warfield) to provide investment management advice for the trust,<sup>95</sup> which, at the beginning of the tax year, held approximately \$2.9 million in marketable securities.<sup>96</sup> On its Form 1041, U.S. Income Tax Return for Estates and Trusts, for the year 2000, the trust reported total income of \$624,816.<sup>97</sup> The fiduciary income tax return also reported, among other things, a deduction of the Warfield investment management fees totaling \$22,241.<sup>98</sup> This deduction was taken on

89. *Id.*

90. *Id.*; see also Jones, *supra* note 39, at 74.

91. William L. Rudkin Testamentary Trust v. Comm’r, 467 F.3d 149, 151 (2d Cir. 2006).

92. *Id.* Henry A. Rudkin’s family was involved in the founding of Pepperidge Farm. Rudkin Testamentary Trust v. Comm’r, 124 T.C. 304, 305 (2005). Pepperidge Farm was acquired by Campbell Soup Company in 1961. Pepperidge Farm: Our History, <http://www.pepperidgefarm.com/history.aspx> (last visited Apr. 10, 2010).

93. *Rudkin*, 124 T.C. at 305.

94. *Id.* at 306.

95. *Id.*

96. Knight v. Comm’r, 552 U.S. 181, 185 (2008).

97. *Rudkin*, 124 T.C. at 306. The Form 1041 for the 2000 year was timely filed on behalf of the trust. *Id.*

98. *Id.*

line 15a for “[o]ther deductions *not* subject to the 2% floor.”<sup>99</sup> There was no deduction claimed on line 15b for “[a]llowable miscellaneous itemized deductions subject to the 2% floor.”<sup>100</sup>

On December 5, 2003, the Commissioner of the IRS (Commissioner) issued to the trust a statutory notice of deficiency for the taxable year 2000.<sup>101</sup> The notice of deficiency indicated that it rejected the trust’s itemized deduction for the investment advisory fees in the amount of \$22,241.<sup>102</sup> Instead, the Commissioner allowed deduction of the portion of the fees that exceeded 2% of the adjusted gross income of \$623,050.<sup>103</sup> The amount found by the IRS to be in excess of the 2% floor was \$9780.<sup>104</sup> The corresponding income tax deficiency amounted to \$4448.<sup>105</sup> The trust subsequently filed a petition in Tax Court disputing the assessed deficiency.

*B. Tax Court & Second Circuit Opinions: Rudkin v. Commissioner*

In its petition to the Tax Court, the trustee argued that the fees were paid in connection with administration of the trust and would not have been incurred if the property were not held in trust.<sup>106</sup> Like the trustees in *Mellon Bank*, the trustees argued that even though an individual may make a voluntary choice to engage an investment advisor, “fiduciary duties render such professional advice a necessary and ‘involuntary’ component of trust administration.”<sup>107</sup> The involuntary nature of retaining an investment advisor to manage the trust assets, the trustees claimed, arose out of their obligation to act as a “prudent investor” under the Connecticut Uniform Prudent Investor Act,<sup>108</sup> which required the trustee to obtain investment

99. *Id.*

100. *Id.*

101. *Id.* The Internal Revenue Service must assess any amount of alleged underpayment of tax within three years after a taxpayer files the taxpayer’s return for a year. JAMES J. FREELAND ET AL., *supra* note 21, at 984.

102. *Rudkin*, 467 F.3d at 306.

103. *Id.*

104. *Id.*

105. *Id.* Following the notice of deficiency, both parties became aware that the notice contained an error in its calculation of the trust’s adjusted gross income. *Id.* It was then stipulated that the correct amount was \$613,263, and, therefore, the corresponding deduction for the investment management advisory fees would be \$9976. *Id.* “However, on account of the alternative minimum tax, the parties are in further agreement that the resultant deficiency if respondent’s position is sustained remains unchanged at \$4,448.” *Rudkin v. Comm’r*, 124 T.C. 304, 306 (2005).

106. *Rudkin*, 124 T.C. at 308.

107. *Id.*

108. The legal duty of prudence has been codified in the Uniform Prudent

advisory services, and, therefore, pay investment advisory fees.<sup>109</sup>

The trustee took the position that the exception in section 67(e) “establishes a straightforward causation test.”<sup>110</sup> The proper inquiry, the trustee argued, is whether a particular expense of a trust or estate was caused by the fact that the property was held in the trust or estate.<sup>111</sup> The investment advisory fees incurred by the trust, therefore, met this test as “these costs [were] caused by the trustee’s obligation to obtain advice on investing trust assets in compliance

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Investor Act in 1994. *See* UNIF. PRUDENT INVESTOR ACT §§ 1-16, 7B U.L.A. 1 (2006); *see also* Brief of Am. Bankers Ass’n et. al. as Amici Curiae Supporting Petitioner, *Knight v. Comm’r*, 581 U.S. 181 (2007) (No. 06-1286). Since 1994, versions of this uniform statute have been adopted by a majority of states and the District of Columbia as the standard for trust investment law. *See* ALASKA STAT. §§ 13.36.225–.260 (2008); ARIZ. REV. STAT. ANN. §§ 14-10901 to -10909 (Supp. 2009); ARK. CODE ANN. §§ 24-2-610 to -619 (Supp. 2009); CAL. PROB. CODE §§ 16045–16054 (West Supp. 2010); COLO. REV. STAT. ANN. §§ 15-1.1-101 to -115 (West 2005 & Supp. 2009); CONN. GEN. STAT. ANN. §§ 45a-541 to -541l (West 2004 & Supp. 2009); D.C. CODE ANN. §§ 19-1309.01–.06 (LexisNexis 2005); FLA. STAT. ANN. § 518.11 (West 2007 & Supp. 2010); HAW. REV. STAT. ANN. §§ 554C-1 to -12 (LexisNexis 2006 & Supp. 2009); IDAHO CODE ANN. §§ 68-501 to -514 (2006); 760 ILL. COMP. STAT. ANN. 5/5, 5/5.1 (West 2007 & Supp. 2009); IND. CODE ANN. §§ 30-4-3.5-1 to -13 (West 2009); IOWA CODE ANN. §§ 633.4301–.4309 (West 2003 & Supp. 2009); KAN. STAT. ANN. §§ 58-24a01 to -24a19 (2006); ME. REV. STAT. ANN. tit. 18-B, §§ 901– 908 (West Supp. 2009); MD. CODE ANN. §§ 14-405(c), 15-114(b) (LexisNexis 2001 & Supp. 2009); MASS. GEN. LAWS ANN. ch. 203C, §§ 1–11 (West 2004 & Supp. 2009); MICH. COMP. LAWS §§ 700.1501–.1512 (West 2002 & Supp. 2009); MINN. STAT. ANN. §§ 501B.151–.152 (West 2009 & Supp. 2010); MO. ANN. STAT. §§ 469.900–.913 (West 2001); MONT. CODE ANN. § 72-34-601 to -610 (2009); NEB. REV. STAT. §§ 30-3883 to -3889 (LexisNexis Supp. 2009); N.Y. EST. POWERS & TRUSTS LAW § 11-2.3 (McKinney 2008 & Supp. 2010); NEV. REV. STAT. ANN. §§ 164.705–.775 (LexisNexis 2009); N.H. REV. STAT. ANN. §§ 564-B:9-901 to -906 (LexisNexis 2006 & Supp. 2009); N.J. STAT. ANN. §§ 3B:20-11.1–.12 (West Supp. 2009); N.M. STAT. ANN. §§ 45-7-601 to -612 (West 2004 & Supp. 2009); N.C. GEN. STAT. ANN. §§ 36C-9-901 to -907 (2009); N.D. CENT. CODE §§ 59-02-08.1–.11 (2004); OHIO REV. CODE ANN. §§ 5809.01–.08 (West 2007 & Supp. 2009); OKLA. STAT. ANN. tit. 60, §§ 175.60–.72 (West Supp. 2010); OR. REV. STAT. §§ 130.750–.755 (West Supp. 2009); 20 PA. CONS. STA. ANN. §§ 7201–7214 (West 2005 & Supp. 2009); R.I. GEN. LAWS §§ 18-15-1 to -13 (West, Westlaw through 2006 Sess.); S.C. CODE ANN. § 62-7-933 (2009); S.D. CODIFIED LAWS ANN. §§ 55-5-6 to -16 (2004 & Supp. 2009); TENN. CODE ANN. §§ 35-14-101 to -114 (West 2007); TEX. PROP. CODE ANN. §§ 117.001–.012 (Vernon 2007 & Supp. 2009); UTAH CODE ANN. §§ 75-7-901 to -907 (West Supp. 2009); VA. CODE ANN. §§ 26-45.3–.14 (2009); WASH. REV. CODE ANN. §§ 11.100.010–.140 (West 2006 & Supp. 2010); W. VA. CODE §§ 44-6C-1 to -15 (LexisNexis 2004); WIS. STAT. ANN. § 881.01 (West 2002 & Supp. 2009); WYO. STAT. ANN. §§ 4-10-901 to -913 (2009).

109. *Knight v. Comm’r*, 552 U.S. 181, 185-86 (2008). *See also* CONN. GEN. STAT. §§ 45a-541a to -541 (2008).

110. *Knight*, 552 U.S. at 189. This “causation test” is the same test set forth by the Sixth Circuit in *O’Neil*. *See* *O’Neil v. Comm’r*, 994 F.2d 302 (6th Cir. 1993), *abrogated by* *Knight v. Comm’r*, 128 S. Ct. 782 (2008).

111. *Knight*, 552 U.S. at 189.

with the Trustee's fiduciary duties."<sup>112</sup>

The Commissioner, basing his arguments on *Mellon Bank and Scott*, argued that because investment advisory fees are commonly incurred by individual investors outside of trust administration, the fees did not meet the second requirement of section 67(e)(1).<sup>113</sup>

The Tax Court, finding its initial interpretation of section 67(e) (set forth in *O'Neill v. Commissioner*)<sup>114</sup> and the ensuing decisions of the Federal and Fourth circuits to be sound, held that the deduction of the investment advisory fees were subject to the 2% floor.<sup>115</sup> The taxpayers subsequently appealed.

The Second Circuit, in a decision written by current Supreme Court Justice Sonia Sotomayor, went a step further in its interpretation of section 67(e) than either the Federal or Fourth Circuit.<sup>116</sup> In its analysis, the Second Circuit agreed with the Fourth Circuit's statement in *Scott* that the second prong of section 67(e)(1) does not ask whether the costs at issue are commonly incurred in the administration of trusts or are incurred as a result of a particular trustee's fiduciary duty. It instead focused on the hypothetical situation where the assets are in the hands of an individual.<sup>117</sup> It is at this point, however, that the court departs from its sister circuits. The court disagreed with the Federal and Fourth circuits' statement that costs "not customarily incurred outside of trusts" are the ones not subject to the [2%] floor."<sup>118</sup> Instead, the court held that the plain meaning of section 67(e) "permits a trust to take a full deduction only for those costs that could not have been incurred by an individual property owner."<sup>119</sup>

In reaching this standard, the Second Circuit reached a result that had not been advanced by either party and was far more

112. *Id.* (internal quotations omitted).

113. *Rudkin Testamentary Trust v. Comm'r*, 124 T.C. 304, 308 (2005). The Commissioner also argued that "neither State law nor the governing trust instrument imposed a legal obligation on the fiduciary to obtain professional investment management services." *Id.* at 309. This is an argument put forth in response to the question left unanswered by the Fourth Circuit in *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), regarding the effect of state law on this issue.

114. 98 T.C. 227, 230-31 (1992).

115. *Rudkin*, 124 T.C. at 311.

116. *Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149 (2d Cir. 2006).

117. *Id.* at 155.

118. *Id.* at 156 (emphasis added) (quoting *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001)).

119. *Rudkin*, 467 F.3d at 156. The court also found the statute's text to be clear and unambiguous and, therefore, refused to address the trustee's legislative history arguments. *Id.* at 157.

restrictive than the position asserted by the IRS.<sup>120</sup> Following this holding, the taxpayer petitioned the Supreme Court for a writ of certiorari, citing the clear conflict among the four circuits.<sup>121</sup> The Department of Justice opposed certiorari, claiming that the conflict would soon be resolved by forthcoming regulations.<sup>122</sup> Unconvinced by the Department of Justice's claims, the Supreme Court granted certiorari under the name *Knight v. Commissioner*<sup>123</sup> in June 2007.<sup>124</sup>

*C. Proposed Treasury Regulations: Treasury's Attempt to Get Out in Front of the Supreme Court*

On July 27, 2007, just over a month after the Supreme Court granted certiorari to Rudkin, the IRS released proposed regulations under section 67(e).<sup>125</sup> The proposed regulations stated that "[t]o the extent that a cost incurred by an estate or non-grantor trust is unique to such an entity, that cost is not subject to the 2-percent floor on miscellaneous itemized deductions."<sup>126</sup> The proposed regulations defined costs as "unique" if "an individual could not have incurred that cost in connection with property not held in an estate or trust."<sup>127</sup> It is clear that the IRS was signaling to the Supreme Court their approval of the Second Circuit's narrow "could not have been incurred" standard set forth by then-Judge Sotomayor.

The proposed regulations set forth a non-exclusive list of certain products or services that the IRS considered "unique" and fully deductible.<sup>128</sup> These products or services included:

Fiduciary accountings; judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters.<sup>129</sup>

120. Jones, *supra* note 39, at 74.

121. *Id.*

122. *Id.*

123. 552 U.S. 181 (2008).

124. Jones, *supra* note 39, at 74.

125. Section 67 Limitations on Estates and Trusts, 72 Fed. Reg. 41,243, 41,245 (proposed July 27, 2007).

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*



The IRS also set forth a non-exclusive list of non-unique products or services that are subject to the 2% floor.<sup>130</sup> These non-unique products and services included: “Custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property.”<sup>131</sup>

One example included in that list has been heavily debated: the inclusion of costs associated with the preparation of fiduciary income tax returns. This issue will be discussed in more detail following the discussion of the *Knight* decision as the IRS may be forced to alter its position taken on this issue in light of the Supreme Court’s holding.

In addition to setting forth the “unique” standard to test the deductibility of trust costs, the proposed regulations also touched on an issue that has been percolating in the background for much of this section 67 litigation and that has now become a very hot topic among corporate fiduciaries—that being how “bundled fees” are to be treated going forward. The proposed regulations addressed the issue as follows:

(c) “*Bundled fees.*” If an estate or a non-grantor trust pays a single fee, commission or other expense for both costs that are unique to estates and trusts and costs that are not, then the estate or non-grantor trust must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estates and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estates and trusts and other costs.<sup>132</sup>

This has been a hot topic as most corporate fiduciaries do not charge separately for their services.<sup>133</sup> Instead, most trustees bundle their services and charge a fee based on a percentage of the value of the trust assets.<sup>134</sup> This bundled fee represents compensation for all fiduciary services, including acting as a custodian for the trust assets, investing the trust assets, filing the trust’s income tax returns, communicating with beneficiaries, and handling any necessary court

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130. *Id.*

131. *Id.*

132. *Id.*

133. RONALD D. AUCUTT, TRUSTS AND THE 2% FLOOR 10 (McGuire Woods L.L.P. 2008), <http://www.mcguirewoods.com/news-resources/publications/taxation/trusts.pdf>.

134. *Id.*

filings.<sup>135</sup> Under the current practice, the bundled fiduciary fees are fully deductible.<sup>136</sup> The effect of “unbundling” fiduciary fees will be discussed later in this article, but one can already imagine the potential challenges and substantial costs associated with requiring corporate fiduciaries to unbundle their fees and separate them into unique and non-unique expenses.

#### IV. THE *KNIGHT* DECISION

In an opinion written by Chief Justice John Roberts, the Supreme Court found in favor of the Commissioner but for different reasons than those given by the Court of Appeals.<sup>137</sup> The Court initiated its analysis by reviewing the language of section 67(e).<sup>138</sup> It immediately took issue with the Second Circuit’s application of the statute, as in the Second Circuit’s analysis the court asked whether the cost at issue *could* have been incurred by an individual.<sup>139</sup> This, the Court found, “flies in the face of the statutory language” of section 67(e).<sup>140</sup> The language of the statute does not ask whether the costs “could not have been incurred” were it not held in trust but instead asks whether the costs “would not have been incurred if the property were not held” in trust.<sup>141</sup> The Court stated that “[t]he fact that an individual could not do something is one reason he would not, but not the only possible reason.”<sup>142</sup> If Congress had intended the narrow application adopted by the Second Circuit, “it easily could have replaced ‘would’ in the statute with ‘could,’ and presumably would have.”<sup>143</sup> The Court found this fact to be strong support for rejecting the Second Circuit’s interpretation of section 67(e).<sup>144</sup>

135. *Id.* For example, under this proposed approach, if 30% of a trustee’s fee is allocable to fiduciary bonds and accountings, fiduciary income tax returns, and distributions and communications to beneficiaries, while 70% of the fee is allocable to custody, management, and investment advice, then only 30% of the fee will be fully deductible as an “above the line” expense [not subject to the 2% floor], and the other 70% will be deductible only to the extent it exceeds 2% of the trust’s equivalent of “adjusted gross income.” *Id.* (alteration in original).

136. Notice 2008-32, 2008-11 I.R.B. 578, at 594.

137. *Knight v. Comm’r*, 552 U.S. 181, 183 (2008).

138. *Id.* at 187–88.

139. *Id.*

140. *Id.*

141. *Id.* at 188 (internal quotation omitted).

142. *Id.*

143. *Id.*

144. *Id.* The Court also went on to find that the Second Circuit’s interpretation of section 67(e) would render the first clause of Section 67(e) (1) superfluous. *Id.* at 188–89. “If the only costs that are fully deductible are those that *could* not be

The Court also rejected the “causation test” for deductibility set forth by the trustee.<sup>145</sup> This causation test, adopted from the Sixth Circuit’s opinion in *O’Neil*, sets forth the proposition that all fees incurred in connection with, or caused by, the trustee’s fiduciary duties are fully deductible and, therefore, not subject to the 2% floor.<sup>146</sup> This interpretation, however, would allow nearly every cost incurred by a trustee to escape the 2% floor of section 67 because a trustee has a fiduciary duty to incur them.<sup>147</sup>

Furthermore, the court found that the adoption of this causation test would render the second clause of section 67(e) superfluous.<sup>148</sup> If section 67(e) set forth a straightforward causation test, then only the first clause of section 67(e) (1) —providing that the cost be “incurred in connection with the administration of the . . . trust”—would be necessary.<sup>149</sup> The second clause of section 67(e) (1)—that the cost also be one “which would not have been incurred if the property were not held in such trust”—would be redundant and, ultimately, unnecessary.<sup>150</sup>

After rejecting the trustee’s causation test approach, the Court moved on to introduce what it found as the correct approach to section 67(e). Section 67(e), the Court found, invites a “hypothetical inquiry into the treatment of the property were it held outside a trust.”<sup>151</sup> It is the “counterfactual question of whether *individuals* would have incurred such costs in the *absence* of a trust” that should

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incurred outside the trust context,” then there would be no reason to include an additional condition on full deductibility that the costs be incurred in connection with the trust’s administration. *Id.* at 189. “We can think of no expense that could be incurred exclusively by a trust but would nevertheless *not* be ‘paid or incurred in connection with’ its administration.” *Id.*

145. *Id.*

146. *See* *O’Neill v. Comm’r*, 994 F.2d 302, 304 (6th Cir. 1993).

147. *Knight*, 552 U.S. at 188.

148. *Id.* at 190.

149. *Id.*

150. *Id.* In addition to rendering the second clause of section 67(e)(1) superfluous, the Court also found that the trustee’s position was “further undermined by [the Court’s] inclination, ‘[i]n construing provisions . . . in which a general statement of policy is qualified by an exception, [to] read the exception narrowly in order to preserve the primary operation of the provision.’” *Id.* (quoting *Comm’r v. Clark*, 489 U.S. 726, 739 (1989)). The general rule set forth by section 67(e) is that gross income of an estate or trust shall be computed in the same manner as an individual. *Id.* at 191. Under the trustee’s interpretation, the exception set forth in section 67(e) (1) would swallow the general rule as most, if not all, expenses incurred by a trust would be fully deductible. *Id.*

151. *Id.*

be the focus of any section 67(e) analysis.<sup>152</sup> This hypothetical counterfactual approach fits squarely with the test adopted by the Fourth and Federal circuits: “Costs incurred by trusts that escape the 2% floor are those that would not ‘commonly’ or ‘customarily’ be incurred by individuals.”<sup>153</sup> It is this test that the Court adopted for determining the tax deductibility of trust or estate expenses.<sup>154</sup>

Having established the correct standard in which to approach section 67(e), the Court proceeded to address the particular issue of the case before them—“whether investment advisory fees incurred by a trust escape the 2% floor” of section 67.<sup>155</sup> Consistent with the standard articulated above, the Court seemed to cut the trustee’s legs out from under him as it stated that the trustee, who had the burden of establishing his entitlement to the deduction, had failed to demonstrate that it is uncommon or unusual for individuals to hire an investment advisor.<sup>156</sup> The foundation of the trustee’s argument was that “he engaged an investment adviser because of his fiduciary duties” to act as a prudent investor under Connecticut’s Uniform Prudent Investor Act.<sup>157</sup> To satisfy the prudent investor standard, a

152. *Id.* (emphasis in original).

153. *Id.* (citing *Scott v. United States*, 328 F.3d 132, 140 (4th Cir. 2003) (“Put simply, trust-related administrative expenses are subject to the 2% floor if they constitute expenses commonly incurred by individual taxpayers.”); *Mellon Bank, N.A. v. United States*, 265 F.3d 1275, 1281 (Fed. Cir. 2001) (Section 67(e) “treats as fully deductible only those trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of trusts.”)).

154. *Id.* Although the solicitor general advocated for the adoption of the Second Circuit’s “could not have been incurred” standard, he also accepted the Fourth and Federal circuits’ test as an alternative reading of section 67(e). *Id.* at 188 n.3, 191.

155. *Id.* at 192.

156. *Id.* (citing *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1992) (noting the “‘familiar rule’ that ‘an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer’” (quoting *Interstate Transit Lines v. Comm’r*, 319 U.S. 590, 593 (1943))). The Court, however, subsequently acknowledged that the reason the trustee had not demonstrated this fact was because the trustee’s argument was not that individuals do not commonly incur investment advisory fees, but that individuals cannot incur *trust* investment advisory fees. *Id.* at 193. It seems odd that the Chief Justice would highlight the trustee’s failure to demonstrate this particular fact, and then provide an explanation for why it had not attempted to do so. At first blush, it seems as though the Chief Justice may have been alluding to the fact that there is no difference between *trust* investment advisory fees and *individual* investment advisory fees. However, in the last paragraph of the opinion he acknowledges that it may be conceivable that some trust-related investment advisory fees may be fully deductible, and therefore different from individual investment advisory fees. *Id.* at 194-95. Regardless of the dicta in the last paragraph, it seems that the Court is deferring to the IRS and the Treasury will make the final determination.

157. *Id.* at 193.

trustee “must ‘invest and manage trust assets *as a prudent investor would*, by considering the purposes, terms, distribution requirements and other circumstances of the trust.’”<sup>158</sup> “[T]he standard looks to what a prudent investor with the same investment objectives handling his own affairs would do . . . .”<sup>159</sup>

The Court did not doubt the trustee’s claim that a hypothetical prudent investor in the trustee’s position would have solicited investment advice.<sup>160</sup> In fact, this claim seemed to further support the Court’s position, as it concluded:

Having accepted all this, it is quite difficult to say that investment advisory fees ‘would not have been incurred’ — that is, that it would be unusual or uncommon for such fees to have been incurred—if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs.<sup>161</sup>

The Court did, however, leave open the possibility that “some trust-related investment advisory fees may be fully deductible ‘if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts.’”<sup>162</sup> It was found to be conceivable “that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper.”<sup>163</sup> In this situation “the incremental cost of expert advice

158. *Id.* (quoting CONN. GEN. STAT. § 45a-541b(a) (2007)) (emphasis in original).

159. *Id.*

160. *Id.* at 193–94.

161. *Id.* at 194.

162. *Id.* (quoting Brief for the Respondent at 25, *Knight v. Comm’r*, No. 06-1286 (U.S. Oct. 11, 2007)).

163. *Id.* at 194–95. Theoretically this argument makes sense. However, in practice, the balancing of interests between current income beneficiaries and remainder beneficiaries is not primarily done by the investment manager; instead they are balanced through the decisions made by the trust administrator. The following is an example of this: Often, non-grantor trusts will have a named income beneficiary to whom the trustee is required to pay out 100% of the net income and principal (corpus) for certain expenses, but at the discretion of the trustee. Such a trust will also have remainder beneficiaries who will receive the balance of the trust upon the death of the income beneficiary. In such a situation, the income beneficiary may be an elder individual whose primary interest is income. The trustee would then work with the investment manager to set up an appropriate investment objective for the trust which would both provide as much income as possible for the income beneficiary, but also provide some opportunity for growth for the remainder beneficiaries. This is the balancing of interests that the Chief Justice was referring to. The problem with this example, however, is that the investment manager will simply assign an investment objective similar to that of an individual with the same goal—

beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor.”<sup>164</sup> In the present case, however, the Court found that the trustee had not asserted that the investment advisory services were distinctive and therefore the fees associated with these services were subject to the 2% floor of section 67.<sup>165</sup>

## V. ANALYSIS OF THE *KNIGHT* DECISION

### A. *Analysis*

When all is said and done, the Chief Justice did what he could with what is, at the end of the day, a terribly written code section. In rejecting the Second Circuit’s interpretation of section 67(e), the Court found that “[i]f Congress had intended . . . [such a] reading, it easily could have replaced ‘would’ in the statute with ‘could,’ and presumably would have.”<sup>166</sup> The Court likely gives Congress too much credit. In its brief to the Supreme Court, the Respondent concedes that “there is no meaningful discussion of Section 67(e) (1) itself in the legislative history.”<sup>167</sup> This seems to make perfect sense as even *some* meaningful discussion or debate over the language of this section would have highlighted the interpretive problems that result from the inclusion of “would” in this code section and the possible problems associated with trustees applying a hypothetical counterfactual to determine the tax deductibility of certain trust expenses. Regardless of the poor drafting of this particular section, the Court was right to restrain itself from making a judicial amendment of the statute.<sup>168</sup>

Instead, the Court adopted the standard applied by the Fourth and Federal circuits.<sup>169</sup> At first glance, this standard seems to

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that being a majority focus on income production with a slight equity holding for growth. Investment industry standards do not provide for specific fiduciary, interest balancing, investment objectives utilized by investment advisors. Instead, the balancing of different beneficiaries’ interests is primarily done by the trustee who helps establish a particular investment objective and makes discretionary decisions for how principal distributions will be made.

164. *Id.* at 195.

165. *Id.*

166. *Id.* at 182.

167. Brief for the Respondent at 33, *Knight v. Comm’r*, No. 06-1286 (U.S. Oct. 11, 2007).

168. *Knight*, 552 U.S. at 194 (“Congress’s decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty, but that is no excuse for judicial amendment of the statute.”).

169. *Id.* at 191.

articulate a middle ground between the standard adopted by the Second Circuit (supported by the IRS) and the standard advocated by the trustee. However, upon further review, the narrow standard adopted by the Second Circuit and the moderate standard adopted by the Court will likely have the same practical effect on what trust expenses are found to be subject to the 2% floor.

The “could not have been incurred” standard advanced by the IRS is clearly the narrowest interpretation of section 67(e). This interpretation would allow only costs which are unique to trust and estate administration—and unable to be incurred by individuals holding similar assets—to be fully deductible. The fact that the IRS advanced this interpretation should be of no surprise as this position would limit the number of deductions, thereby yielding higher tax revenue.

The causation test advocated by the trustee, on the other hand, is as broad a standard as can be applied to questions of tax deductibility. This test would allow any expense incurred by the trust to be fully deductible if the expense could be shown to result from the trustee’s fiduciary duties. The Court was correct in its criticism of the trustee’s position<sup>170</sup> because nearly every trust expense is incurred as the result of some fiduciary duty of the trustee. Adoption of this test would allow nearly every trust expense to escape the 2% floor of section 67.

In the middle lay the “not commonly or customarily incurred” standard adopted by the Supreme Court.<sup>171</sup> After reading the Chief Justice’s opinion, this standard would seem to allow more to escape the 2% floor than that of the Second Circuit’s standard, but would also limit expenses not unique to trust administration to those not commonly or customarily incurred by individuals, which is a narrower scope than that of the causation test. Herein lies the problem. In practice there are very few expenses incurred by non-grantor trusts that are not unique to trust administration and that are also not commonly or customarily incurred by individuals holding the same or similar assets. The only expenses likely to fall into this category are those associated with the services of specialty asset managers.

Specialty asset managers are responsible for the administration and management of non-financial assets held in trusts. Examples of specialty assets that fall outside the classification of standard financial assets are real estate, closely held business interests, farm/ranch

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170. See *id.* at 189–91.

171. See *id.* at 191.

property, and oil, gas, and mineral interests.<sup>172</sup> Non-grantor trusts with corporate fiduciaries as named trustees commonly use specialty asset managers to handle these types of assets. The expenses associated with the services of specialty asset managers are different from trust administration fees as they are not incurred as the result of the asset being held in trust. Instead, they are more akin to investment advisory fees as they are typically incurred as the result of the fiduciary duty of the trustee. Unlike investment advisory fees, specialty asset management fees are not necessarily commonly or customarily incurred by individuals who hold the same or similar assets.

For example, a non-grantor trust being managed by a corporate trustee that holds an interest in a closely-held business will often have a specialty asset manager or business advisor handle any number of issues related to the closely-held business such as business valuation, succession planning, asset management, or even sales services. Would these specialty asset manager/business advisory fees be fully deductible under the standard set forth in *Knight*? On the one hand, they are not trust specific expenses, but on the other hand, they are not nearly as commonly incurred as investment advisory fees, for example. This would seem to be the uncommon example of a fee that would be subject to the 2% floor under the Second Circuit's standard, yet would be fully deductible under the standard adopted in *Knight*.

Under the current common practice, however, the trust's fiduciary income tax preparer would not even conduct this analysis because most specialty asset management fees are bundled into one fee along with the trust administration and investment advisory fees.<sup>173</sup> If trustees are not required to unbundle their trust management fees, then the practical outcome of the standard adopted in *Knight* will be no different than the narrow standard advocated by the IRS. It logically follows that, in order to effectuate the goals of the standard

172. See J.P. Morgan, Specialty asset management, [http://www.jpmorgan.com/pages/jpmorgan/private\\_banking/foundations/specialty\\_asset\\_management](http://www.jpmorgan.com/pages/jpmorgan/private_banking/foundations/specialty_asset_management) (last visited Apr. 11, 2010); Wells Fargo, Real Estate & Specialty Assets, <https://www.wellsfargo.com/investing/pcs/business/assets> (last visited Apr. 11, 2010).

173. See Wells Fargo Investment Management & Trust Fee Schedule (Effective Date Oct. 2006) (on file with author). It is important to note that corporate trustees who utilize this type of bundled fee typically reserve the right to charge special fees for extraordinary services—beyond or in place of the bundled fee—resulting from the management of these specialty assets. *Id.* at 2.



adopted by the Court in *Knight*, the Department of the Treasury must—to the dismay of all corporate fiduciaries—issue finalized regulations requiring some form of unbundling trust management fees. This is a logical conclusion to reach after analyzing the different standards articulated by each court and applying them to the practical aspects of trust administration.

There is, however, another possible conclusion that one can reach with regard to the language of section 67(e) (1). To reach this conclusion, one must take a step back and disregard the legal arguments set forth by each side above and read the following passage as an individual with no legal training would:

[T]he deductions for costs which are paid or incurred in connection with the administration of . . . the trust and which would not have been incurred if the property were not held in such trust . . . shall be treated as allowable in arriving at adjusted gross income.<sup>174</sup>

Is it possible that the “which would not have been incurred if the property were held in such trust” clause of section 67(e) (1) has been overstated by parties and courts as a “second prong” of a statutory test?<sup>175</sup> With the acknowledged absence of any Congressional intent to establish such a statutory test, it seems entirely possible that this “second prong” is nothing more than a completion of the overall thought of a relationship to trust administration.<sup>176</sup> But faced with diverging circuit court standards, the Supreme Court was forced to make sense of a senseless statute. And instead of judicially amending the statute itself, the Court adopted a standard which, in the end, affords the Treasury substantial latitude in its application. This latitude exists in the Treasury’s ability to define what constitutes “common” and “customary” in its regulations to section 67.

Some commentators argue that by adopting this standard, the Court simply added to the confusion surrounding the exception rather than clarifying its application.<sup>177</sup> Instead, the Court’s position can be interpreted as simply laying out the boundaries of the Treasury’s future regulations. The Treasury and IRS now have an opportunity to step back from the proposed regulations released in July 2007 and work on articulating an application of the statute,

174. I.R.C. § 67(e) (1) (2010).

175. AUCUTT, *supra* note 133, at 19.

176. *Id.*

177. Lindsay Roshkind, *Interpreting I.R.C. § 67(E): The Supreme Court’s Attempt to Nail Investment Advisory Fees to the “Floor,”* 60 FLA. L. REV. 961, 970 (2008).

consistent with the fairly broad guidance provided in the *Knight* opinion. This course of action is fair, cost-effective, and administratively feasible for the IRS and fiduciaries alike.

### *B. IRS and Treasury Interim Guidance*

On February 27, 2008, following the decision in *Knight*, the IRS issued Notice 2008-32, which provided interim guidance on the treatment of investment advisory fees under section 67.<sup>178</sup> The Notice extended a grace period in which taxpayers would not be required to unbundle fiduciary fees for any taxable years beginning before January 1, 2008.<sup>179</sup> In addition to extending this grace period, the Notice also requested that comments be submitted by interested parties.<sup>180</sup>

Many comments were filed in response to the Treasury's request.<sup>181</sup> Generally, these comments asserted that the unbundling of fiduciary fees should not be required<sup>182</sup> and, in any event, that the

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178. Notice 2008-32, 2008-11 I.R.B. 593.

179. *Id.* at 594.

180. *Id.*

181. Roy M. Adams, *Coping With Change—Like It or Not*, 17TH ANN. EST. & CHARITABLE GIFT PLAN. INST., Sept. 14, 2009, at 71.

182. *Id.* The Committee on Estate and Gift Taxation of the New York City Bar Association also took the following positions:

1. The Proposed Regulations' requirement that bundled fees be unbundled should be eliminated as it is contrary to Section 67(e) and the view expressed by each of the federal courts that have commented on the deductibility of trustees' fees.

2. If, however, the Service is not inclined to eliminate its unbundling requirement, then a trust or estate should be allowed to deduct without regard to the 2% floor the portion of its bundled fiduciary fee that would not be commonly incurred by individuals, as determined based upon the fiduciary's books and records and using any reasonable method of allocation that the fiduciary may select. The fiduciary's determination may take into account the exceptions set forth near the end of the Supreme Court's decision in *Knight*, including for special additional charges that are applicable only to fiduciary accounts, and the incremental cost of expert advice beyond what would normally be incurred by individuals.

3. As an alternative to providing allocations based upon its books and records, a fiduciary should also be allowed a safe harbor to deduct without regard to the 2% floor *the greater of* [A] the amount of the total fiduciary commissions that would be allowed under the applicable state statute governing the commissions of individual fiduciaries, [B] a specified percentage of the fiduciary commissions (such as 50%) to be determined by the Service, and [C] the amount of the allocations to fully deductible costs based upon the fiduciary's generally applicable published fee schedule.

*Id.* at 71–72.

IRS should provide guidance to clarify that neither taxpayers nor tax practitioners will be subject to penalties relating to 2% floor issues unless the taxpayer's position has no realistic possibility of being sustained on its merits.<sup>183</sup>

The comments against the proposed regulations' unbundling requirement differentiated unitary (bundled) fees from the investment advisory fees—those which were found to be subject to the 2% floor in *Knight*—by arguing that the unitary fees were simply fiduciary fees, which have always been held to be fully deductible<sup>184</sup> and, in what seems to be a throwaway argument, that nothing in the Court's opinion in *Knight*, or in section 67(e) itself, specifically requires unbundling. Advocates of this position point to the fact that fiduciary income tax return preparer fees are fully deductible under section 67(e), whereas individual tax return preparer fees are subject to the 2% floor.<sup>185</sup> But is it really enough to say that these fees are unique because the fiduciary must file a Form 1041 but an individual must file a Form 1040? Although the Supreme Court did not focus on preparer fees in *Knight*, the justices expressed some trepidation about this line of reasoning during oral arguments in that case.<sup>186</sup> Justice

183. *Id.* at 72. Significant changes to tax return preparer penalties were made when Congress enacted the Small Business and Work Opportunity Act of 2007. Specifically, the new standard requires that a tax return position be disclosed unless there is 'reasonable belief that the [filing] position would more likely than not be sustained on its merits.' This is a fairly significant step up in comparison to the previous 'good faith' standard. See Craig L. Janes, *Between Monsters—The Section 67(e) Prop. Regs. And Section 6694*, 35 EST. PLAN. 19 (2008).

184. Adams & Hoyt, *supra* note 181, at 72.

185. Craig L. Janes, *supra* note 183, at 19.

186. The Court did not address deductibility of fiduciary tax preparation fees in the opinion, but the issue was discussed in oral arguments. See *Knight v. Comm'r*, 552 U.S. 181 (2008). The following is an excerpt from oral arguments in which Justice Souter addressed attorney Eric Miller, an assistant to the Solicitor General, who represented the IRS:

JUSTICE SOUTER: Yes, but it's the individual who has to file the 1040. What the trustee is filing is the 1041. And—I was going to ask the same question that Justice Alito did, and that is why do you place so much significance either in the label, i.e., it's fiduciary return, or in peculiar fact that it is a fiduciary who is filing that return?

It's a tax return and—and I think your—the government's argument is that with respect to—to other items that may be disputed, you should regard them at a fairly general level, i.e., investment advice, not fiduciary investment advice. But when you come to the tax return, you don't regard it as a general—at a general level; you regard it at a very specific level, i.e., a fiduciary tax return. It seems to me that the government with respect to the tax return is doing exactly what it criticizes the taxpayer for doing with respect to investment advice. And I don't understand the distinction.

Souter seemed to take issue with the government's position that fiduciary income tax return preparer fees are fully deductible yet investment advisory fees incurred by a fiduciary are not.<sup>187</sup> Chief Justice Roberts pointed out the possible effects of this distinction while discussing how a "customary" or "common" standard would be applied. He suggested that if the above logic were followed, investment advisors would simply self-label themselves as "fiduciary advisors," which would allow their fees to be fully deductible by the trusts they advise.<sup>188</sup>

Justice Souter highlighted what will likely be the major issue that the IRS and Treasury must address: how will the regulations define what is "customary" and what is "common?" If defined narrowly, fiduciary income tax return preparer fees and fiduciary investment advisory fees are not customarily or commonly incurred merely because individuals do not incur "fiduciary" fees and expenses. If

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Transcript of Oral Argument at 31–32, *Knight*, 552 U.S. 181 (No. 06-1286).

187. *Id.*

188. *See id.* at 39–40. The following is an excerpt from oral arguments of a discussion between Chief Justice Roberts and Eric D. Miller, Esq., an assistant to the Solicitor General, who represented the I.R.S.:

CHIEF JUSTICE ROBERTS: So how does your customary or commonly incurred test work? Let's say you have two trusts, one \$10 million, the other [\$]10,000. I think an individual with \$10 million might well seek investment advice, but an individual with only [\$]10,000 might decide it's not worth it. Would you have a different application of the 2 percent rule for those two trusts?

MR. MILLER: I think if the test is whether—whether the individuals would have—would commonly ordinarily incur that cost, I think one might well look at that because the comparison would be individuals with similar assets, and, as Your Honor knows, there might be a difference depending on the size.

CHIEF JUSTICE ROBERTS: How many—how many individuals do you need? Let's say it's \$3 million in the trust, and we think maybe 60 percent of people would hire an investment advisor; 40 percent would think they can do just as well on their own. Is that customarily incurred by individuals?

MR. MILLER: I think it might well be enough that—for something that the Service could clarify through—

CHIEF JUSTICE ROBERTS: Your answer to both questions is "might well be," and that's a fairly vague line when it comes to taxes.

MR. MILLER: The—

JUSTICE SCALIA: And whatever line you—you pick, I guarantee you, trusts are going to break themselves up into mini-trusts that fall under the line. I mean people aren't stupid. (Laughter.)

CHIEF JUSTICE ROBERTS: Or, even worse, advisors are going to break themselves up into different advisors. There's going to be somebody who says I'm a fiduciary advisor whenever a trustee calls, but, I'm a normal advisor, when it's an individual.

*See id.*

defined from a broader perspective, income tax return preparer fees and investment advisory fees are fees commonly incurred by individuals, and are therefore subject to the 2% floor.<sup>189</sup>

It seems as though the IRS and Treasury will be forced to choose between these two perspectives on what constitutes “common” or “customary.” And, after completing the above analysis, it seems likely that the IRS and Treasury will adopt the broad perspective because the narrow perspective seems to mirror the causation test rejected by the Court in *Knight*. If a broad perspective is taken with regard to the “common or customary” standard, the treatment of fiduciary income tax preparer fees will have to be changed as a result. Unless the IRS can articulate how exactly the preparation of a fiduciary income tax return is sufficiently unique as opposed to fiduciary investment management fees, the fees associated with preparing a fiduciary income tax return should be subject to the 2% floor. A major risk of adopting too broad of an approach to this standard is that it could completely emasculate the exception Congress enacted, unless Congress stepped up to remedy the situation by clarifying such a poorly written statute.<sup>190</sup>

In any event, with regard to the bundled fees, the IRS and Treasury should take into consideration the fact that this fee structure is welcomed by most grantors and beneficiaries alike.<sup>191</sup> Although the unbundling of a fiduciary’s fee “may be a superficially appropriate way to encourage similar treatment of similar taxpayers, it would operate imperfectly in the marketplace of negotiated fee structures . . . and it would represent one more administrative burden in conflict with Congress’s stated purposes” of section 67—efficiency and ease of administration.<sup>192</sup>

The IRS and Treasury have yet to release finalized regulations to this section. Although Notice 2008-32 stated that “final regulations under [Section] 1.67-4 [would] be published without delay”<sup>193</sup> after the noted comment period, the IRS and Treasury subsequently released Notice 2008-116, which extended the grace period under the

189. See *id.* at 31–32.

190. Robert S. Balter & Jonathan G. Blattmachr, *Knight v. Comr.: The Two Percent Floor and a Fiduciary’s Investment Advisory Fees*, 49 TAX MGM’T MEMO. 155, 171 n.94 (2008) (comparing GRAY, *THE NATURE AND SOURCES OF THE LAW* 180 (1909) (“It is not as speedy or as simple a process to interpret a statute out of existence as to repeal it, but with time and patient skill, it can often be done.”)).

191. AUCUTT, *supra* note 133, at 20.

192. *Id.*

193. Notice 2008-32, 2008-11 I.R.B. 578 at 594.

previous Notice to include taxable years beginning in 2008.<sup>194</sup> Notice 2008-116 has since been modified and superseded by Notice 2010-32, which again extended the grace period to taxable years beginning before January 1, 2010.<sup>195</sup>

### C. Safe Harbors

In light of the Supreme Court's holding in *Knight*, many commentators have suggested that Treasury consider adopting safe harbors from unbundling.<sup>196</sup> One option, for example, is that "the proposed unbundling obligation should apply *only* to amounts that are substantial and significant—and fundamentally that means *only to investment advisory fees and security custody fees*."<sup>197</sup> In most cases these are the largest and most significant expenses incurred by fiduciaries.<sup>198</sup>

The use of safe harbors is seen by some as a simplification for tax reporting purposes.<sup>199</sup> But even if the unbundling requirement is limited to investment advisory fees and security custody fees, for example, the fundamental problem of unbundling remains: "[U]nbundling each telephone call, meeting, letter, note and memo, not to mention emails, into their respective constituent phrases and subject matters, and then into each one's allocable portions of the costs . . . is not practicable and will be extraordinarily burdensome if not absolutely impossible."<sup>200</sup>

Others view safe harbors in yet a different light. Some feel that safe harbors would merely serve as a "complication for fiduciaries, who—as with many elections under the tax law—would be compelled by fiduciary duty to calculate the outcome both under the safe harbor and under a more customized 'reasonable method' that might be more favorable to the beneficiaries."<sup>201</sup>

In addition to being seen as a simplification for tax reporting purposes, safe harbors may also serve as an alternative to requiring the Treasury to clearly articulate what constitutes "common" or "customary," as set forth in *Knight*. This alternative, however, is the source of some suspicion as it is seen "as an unsettling sign that

194. Notice 2008-116, 2008-52 I.R.B. 1351 at 1357.

195. Notice 2010-32, 2010-15 I.R.B. 594 at 594.

196. Balter & Blattmachr, *supra* note 190, at 168.

197. *Id.* (emphasis in original).

198. *Id.*

199. See AUCUTT, *supra* note 133, at 23.

200. Balter & Blattmachr, *supra* note 190, at 168.

201. AUCUTT, *supra* note 133, at 23.

Treasury and the [IRS] are not open to more bold, comprehensive, and simplifying exceptions for fiduciaries that would make safe harbors unnecessary . . . .”<sup>202</sup> Regardless of the noted deficiencies, the adoption of safe harbors is a distinct possibility, as their potential use was signaled in Notice 2008-32 when it stated that “[t]he final regulations may contain one or more safe harbors for the allocation of fees and expenses between those costs that are subject to the 2-percent floor and those that are not.”<sup>203</sup>

## VI. CONCLUSION

The estate planning and wealth management community had high expectations when the Supreme Court granted certiorari in the *Knight* case. These expectations were rooted in the fact that for more than twenty years, since the adoption of section 67, trustees were unsure as to how the 2% floor applied to certain fiduciary fees and expenses. The Supreme Court took on the case to resolve a long-running conflict among federal appeals courts. There was hope that the Supreme Court would settle this conflict and establish a bright-line rule by which both the IRS and trustees would be able to determine with certainty which fiduciary expenses would be fully deductible and which expenses would be subject to the 2% floor.

The opinion, while logical and well written, did little to clarify the confusion which surrounds section 67(e). Instead, the Supreme Court seemed content in setting the boundaries within which the IRS and Treasury would be allowed to make their own clarification—specifically, what constitutes “common” or “customarily.” This clarification, however, has yet to be made. In issuing the final regulations, the IRS and Treasury should avoid setting forth a rule that would require a case-by-case analysis of each and every fiduciary fee or expense. Instead, they should issue a bright-line rule that is cost-effective and reasonable to administer for both fiduciaries and for the IRS.

Given the language of section 67(e), establishing this bright-line rule is easier said than done. Depending on the success that the IRS and Treasury have with setting forth this rule, the next logical step is for Congress to address the poorly written statute. This process, however, may take longer than the two decades it took courts to address this issue. But until Congress inserts itself into this process,

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202. *Id.*

203. Notice 2008-32, 2008-11 I.R.B. 578 at 594.

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trustees will wait patiently in tax law limbo for the finalized regulations—hoping some reasonable guidance will be provided.